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RUEHNE/AMEMBASSY NEW DELHI 1384
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RUEHIL/AMEMBASSY ISLAMABAD 7408
RUEHKT/AMEMBASSY KATHMANDU 5535
RUEHCG/AMCONSUL CHENNAI 8001
RUEHLMC/MILLENNIUM CHALLENGE CORPORATION

UNCLAS SECTION 01 OF 03 COLOMBO 001305

SIPDIS

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STATE FOR SCA/INS AND EEB/IFD/ODF
STATE PASS USTR FOR DARLA BROWN AND ADINA ADLER
DOL/ILAB FOR TINA MCCARTER
MCC FOR S. GROFF, D. TETER, D. NASSIRY AND E. BURKE
TREASURY FOR LESLIE HULL

E.O 12958: N/A
TAGS: ECON EFIN ETRD KMCA CE
SUBJECT: SRI LANKA: 6.2% GDP GROWTH IN FIRST HALF OF 2007 AMIDST
CONTINUED HIGH INFLATION AND DECLINING EXCHANGE RATE

REF: COLOMBO 1056

¶1. (U) Summary and comment: Sri Lanka's GDP grew at an annual rate of 6.2% for the first half of 2007. The trade deficit narrowed as export growth significantly exceeded import growth. Growing remittances compensated for much of the trade deficit and boosted foreign exchange reserves to a level sufficient to cover three months of imports. Average annual inflation returned to the 17% range after moderating somewhat earlier in the year, as the Central Bank continued to finance the government's deficit spending and imported commodity prices rose. The high inflation drove the Sri Lankan Rupee to historic lows against the dollar, Euro, and Indian Rupee. The Colombo Stock Exchange recovered somewhat from a large drop following Tamil Tiger attacks in March and April, but remains down 5% for the year. Business confidence, as indicated by a monthly Nielsen survey, is at a three-year low.

¶2. (SBU) The 6.2% growth rate is respectable for a country in the midst of a long civil conflict, but it suggests Sri Lanka won't see the 7.5% growth the government has been predicting for 2007. High inflation is a more serious liability for the populist Rajapaksa government, with public concern growing over the rising cost of living. However, the government has avoided the sacrifices necessary to reduce inflation. Its projected 2007 budget deficit is 7.8% of GDP, despite recently instructing all ministries to defer capital spending. The Central Bank likewise is ducking tough choices -- instead of raising interest rates enough to dampen still strong consumer demand and investment, it has tried to use administrative measures and "moral suasion" to discourage banks from lending. Beyond all this, the one measure that could improve all the economic trends would be for the government to decisively pursue a peaceful solution to the conflict. End summary and comment.

6.2% GDP GROWTH IN FIRST HALF OF 2007
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¶3. (U) The Sri Lanka Department of Census and Statistics reported September 13 that second quarter 2007 GDP growth was 6.4%. This brought GDP growth for January-June 2007 to 6.2% -- below the government's target of 7.5-8% and below the 7.8% growth registered in the first half of 2006. Services, the largest sector, grew by 6.5%, boosted by rapidly expanding telecommunications and strong

growth in banking and finance. These outweighed a 19% decline in the tourism-driven hotel and restaurant category. The manufacturing sector grew by 7.5% with textiles and apparel expanding strongly by 12.7%. In the agricultural sector, which grew by 3.5%, both tea and rice production contracted, the latter by 7.6% due to a reduction in cultivation in the east caused by the conflict.

TRADE DEFICIT NARROWS
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¶4. (U) Exports increased strongly by 13% to $3.56 billion and imports increased by 4% to $5.15 billion in the first half of 2007. Consequently, Sri Lanka recorded a trade deficit of $1.58 billion compared with $1.79 billion in 1H2006. Textiles and garments, Sri Lanka's largest export category, rose 15%. Other manufactured exports were also strong. Exports to the United States, Sri Lanka's largest market, recorded a marginal decline however. Exports to the EU increased sharply, on the growth of duty-free garment sales under the EU's GSP Plus program. Agriculture products, which account for about a fifth of total exports, grew by 9%.

¶5. (U) Sri Lanka's January-June petroleum import bill decreased by 8%, helping to contain the overall increase in imports. This was not due to reduced consumption, however. Instead, Sri Lanka had higher than normal petroleum stocks at the beginning of 2007; total oil import costs are expected to pick up again in the second half of the year. Consumer and capital goods imports each increased by 9%. Imports of intermediate goods were flat, mainly due to lower oil and fertilizer imports. In the capital goods category, building materials and transport goods increased strongly. Machinery imports recorded a marginal decline of 1 percent.

REMITTANCES CONTINUE TO INCREASE



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¶6. (U) Remittances, Sri Lanka's second largest source of foreign exchange after garment exports, increased by 18.4% to $1.3 billion in the 1H2007. Net private remittances financed nearly 70% of the trade deficit in the first half of 2007. According to estimates of the Sri Lanka Bureau of Foreign Employment, 1.5 million Sri Lankans were working abroad as of 2006.

INFLATION REMAINS HIGH
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¶7. (U) Inflation, as measured by the Colombo Consumer Price Index (CCPI), was high, with prices in August 17.3% higher than a year earlier. Since 2006, inflation has been driven by both demand and supply side pressures. On the demand side, government deficit spending has been partially financed by the Central Bank and partially from local and international borrowing. Low real interest rates have fed continued private sector credit expansion. Growing remittances have also contributed to strong consumer spending. On the supply side, prices rose for imported commodities including oil, fertilizer, wheat, and milk powder. Reduced government subsidies on petrol, diesel and kerosene caused these prices to rise. Depreciation of the Sri Lankan Rupee also contributed to the rising local prices of imported commodities.

EXCHANGE RATE DECLINES DESPITE CENTRAL BANK VIEWS
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¶8. (U) The Sri Lankan Rupee has depreciated 5.7% against the U.S. dollar so far this year, setting record low rates almost daily in recent weeks. Currently, the Rupee is trading around 113.5 against the dollar, down from 107.7 at the beginning of the year. The rupee has depreciated even more strongly against the Pound, Euro, and Indian Rupee. Forward rates for the Rupee indicate markets expect it to decline further: the six month forward rate is currently around 120 Rupees to the dollar. The depreciation has been driven by a combination of high inflation, the trade deficit, and high demand for dollars -- both by speculators and importers hedging against expected continued declines in the Rupee.

¶9. (U) Because the depreciated Rupee makes both imports and debt service more costly, the Central Bank has sought to shore up its value. In July and August the Bank spent about $150 million in reserves to buy Rupees, which slowed but did not reverse the slide. Giving up this approach, the Bank issued a statement on August 30 saying the "undue depreciation of rupee" was "not based upon any fundamental macroeconomic factors." The Bank's intervention did not substantially reduce reserves: at the end of August, gross official reserves were $2.67 billion, providing an import cover of three months, having risen from $2.52 billion at the beginning of the year.

STOCK MARKET DOWN 5% SO FAR THIS YEAR
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¶10. (U) The Colombo Stock Exchange, which was on a steady downward trend since the March and April Tamil Tiger air attacks near Colombo, bottomed out in mid-July and has recovered somewhat since then. Currently, the All Share Price Index is down 5% since the beginning of the year and 14% from the all-time high it reached in February. Stock brokers attribute the upturn to the relatively stable security environment since April, the government's military gains in the Eastern Province, and attractive price-to-earnings levels at the market's ebb. Top listed companies have reported declining net profits as a result of inflation, high interest costs, and rising taxes. On a sectoral basis, telecoms, banks, and conglomerates have done well, as have tourism companies that have investments in Maldives.

BUSINESS CONFIDENCE INDEX AT A THREE-YEAR LOW
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¶11. (U) The Lanka Monthly Digest-ACNielsen Business Confidence Index (BCI), which surveys 100 senior top executives in Colombo, has



fallen for five straight months to a 35-month low. In the August survey, 85% of respondents viewed Sri Lanka's investment prospects as being poor or very poor and 53% expected sales volumes to get worse in the coming twelve months.

COMMENT: NO SILVER BULLET, EXCEPT FOR PEACE
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¶12. (SBU) The 6.2% growth rate is certainly respectable for a country in the midst of a long civil conflict, but it is less than the government hoped to see after frequent public statements by ministers and the Central Bank governor that the economy is on track for 7.5% growth this year (reftel). The high inflation rate is a more serious liability for the Rajapaksa government, as daily headlines and opposition criticism reflect real public concern over the rising cost of living. However, the government has not been willing to make sufficient sacrifices to bring inflation down. It has made some easy choices, such as trying to limit its projected $2.6 billion budget deficit by instructing all ministries to defer capital spending. The harder choices would be for the government to cut electricity and kerosene subsidies, and for the Central Bank to raise interest rates enough to dampen still strong consumer demand and investment. Perhaps the hardest of all, but the one measure that could improve all the economic trends, would be for the government to decisively pursue a peaceful solution to the conflict.
BLAKE